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Kelly Gunderson

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A Comparative Analysis of Spain's Startup Co-Investment Fund and the United States Government Funded Venture Capital

BY KELLY GUNDERSON*

I. Introduction

The entrepreneurial character of United States has not only created new job opportunities and sponsored the economy, but also formed a society where citizens may take pride in owning their own businesses and creating ideas that change the world.[1] Larry Page and Sergey Brin are a classic example of American entrepreneurial spirit, transforming their garage filled with computers into the world-renowned search engine, Google.[2] Innovation through new venture start-ups has been shown to have a direct effect on the growth of a country's overall economy.[3]

Nations seeking to improve their economy, therefore, are naturally looking to foster innovation and start-ups within their country. Among the most common barriers to such growth are lack of capital to finance new ideas and the lack of experience typical of

* J.D. Candidate 2015, University of California Hastings College of the Law; B.A. University of California, Davis 2010. I would like to thank Professor Abraham Cable for his immeasurable guidance in writing this note. I would also like to thank my parents, Jane and Gary, for your endless support of my education and career.

1. Legal scholars have given great attention to the "funding gap" issue in venture capital financing. *E.g.* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003).

2. *E.g. Our History in Depth*, GOOGLE (Feb. 1, 2014, 12:43 PM), http://www.google.com/about/company/history/.

3. *E.g.* JOSH LERNER, BOULEVARD OF BROKEN DREAMS 43 (2009).

those with innovative ideas.[4] In order to overcome these hurdles, young start-ups look to venture capital ("VC") to provide the necessary funding and guidance, including "business contacts, strategic advice and other managerial support."[5] Furthermore, the use of VC has been shown to shorten the time for young start-ups to have an initial public offering ("IPO"), which has a variety of benefits that will be discussed at greater length in this paper.[6]

VC, however, does not come without risk to the investors. Given the early stage in which investors are financing the company, there is an increased risk the start-up will not perform as projected.[7] Another concern for VC investors is the uniquely unilateral hold of information by the innovators and entrepreneurs seeking funding.[8] While the VC investor may have minimal to no knowledge regarding the product for which funding is sought, the entrepreneur has uniquely in-depth knowledge that leaves the investor at a disadvantage.[9] This "information asymmetry" problem is amplified by the complicated nature of many start-ups. Whether it is a biotechnology start-up using complex DNA sequencing, or a computer technology start-up involving a large amount of coding, investors will often lack the requisite knowledge to fully understand the product.[10]

Finally, Professor Ronald Gilson notes the issue of potentially high agency costs.[11] These costs include the danger of an entrepreneur's goals of self-enrichment and investors often not reaping the benefits of

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4. Christian Keuschnigg, *Optimal Public Policy for Venture Capital Backed Innovation* 1 (Risk Capital and the Financing of European Innovative Firms, Working Paper No. 004, 2003).

5. *Id.*

6. Thomas Hellmann & Manju Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, 13 THE REV. OF FIN. STUD. 959, 959-984 (2000).

7. Gilson, *supra* note 1, at 1076. Ronald Gilson explains the major problems the U.S. VC has faced in forming its VC industry that are mostly unique to this kind of large early stage investment. He then explains the measures taken by VCs in order to protect their investments.

8. *Id.* at 1077.

9. *Id.*

10. *Id.*

11. *Id.*

their investments for a long time, if at all.[12] All of these concerns facing VC financers explain why a country that desires to increase its nation's economy via innovative start-ups must be cautious to build an infrastructure that eases the potential risks for investors.

This paper will analyze Spain's new government funded venture capital program, the Startup Co-Investment Fund ("SCIF"), in order to determine its likelihood of success in Spain and whether other countries should also look to a similar program in order to build their VC market. To effectively examine the new program it will be helpful to carefully explore the U.S.'s venture capital market and history, as the U.S. ranked number one for VC in 2013, while Spain remained at number twenty-seven.[13] This paper will particularly focus on the U.S.'s most successful region, Silicon Valley.[14] Spain currently faces a need for reform of its VC market, as it is losing some of its greatest minds and entrepreneurs to countries that are more favorable for start-ups, like the U.S.[15] This drain of some of Spain's foremost innovators is undoubtedly having a negative effect on the economy.[16] "Access to capital in Spain has been shown to be one of the most significant challenges that entrepreneurs face for starting and growing a technology business."[17] Laura Bottazzi's and Marco Da Rin's article explained, "a vibrant venture capital industry is the cornerstone of America's leadership in the commercialization of technological innovation, and the lack of venture capital hinders European firms from competing on equal footing."[18]

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12. *Id.*

13. Alexander Groh, et. al., *The Global Venture Capital and Private Equity Country Attractiveness Index*, IESE Bus. School Univ. of Navarra (2013) http://blog.iese.edu/vcpeindex/spain/.

14. PricewaterhouseCoopers National Venture Capital Association, *Regional Aggregate Data* (Jan. 12, 2014), *available at* https://www.pwcmoneytree.com.

15. Manuel Baigorri, *Spain's Startups Leave in Search of Venture Capital*, BLOOMBERG (Apr. 21, 2013, 3:01 PM), http://www.bloomberg.com/news/2013-04-21/spanish-preference-for-property-over-startups-deepens-woe-tech.html.

16. Alan Clendenning, *Class of 2012: Young Spaniards buck crisis with risky startups, braking with tradition*, CANADIAN PRESS (Mar. 10, 2013).

17. Itxaso del-Palacio et al., *The Capital Gap for Small Technology Companies: Public Venture Capital to the Rescue?*, 38 SMALL BUS. ECON. 283, 284 (2012).

18. Laura Bottazzi and Marco Da Rin, *Venture Capital in Europe and the Financing of Innovative Companies*, 17 ECON. POL'Y 229, 231 (2002); *See generally*, European Commission, *Green Paper on Innovation*, 688 (Dec. 1995).

The IE Business School of Madrid and the Empresa Nacional de Innovación ("ENISA"), a government organization created to stimulate growth among small to medium size companies, came together to create the SCIF.[19] The SCIF was enacted on September 12, 2012 and matches equity investments by accredited investors for loans of up to 1.5 million euros.[20] Government sponsored VC can assist in the important act of creating an infrastructure that enables innovation and start-ups to thrive.[21] This infrastructure includes trained lawyers and accountants who, with prior training, will be able to provide more cost effective assistance to start-ups.[22] In what Josh Learner refers to as a "virtuous cycle," these "pioneering entrepreneurs and venture capitalists pave the way for subsequent generations: in a given city."[23] Also, government funded VC can play the important role of giving a government certification that the VC market is credible, providing a viable option for investors and entrepreneurs.[24]

In determining the effectiveness of the SCIF and the likelihood of success in stimulating the Spanish VC market I will look at the U.S.'s VC history and the pillars that have created the thriving industry in places like Silicon Valley. Then, it will be beneficial to take a closer look at U.S. government-initiated VC programs. I will then analyze Spain's VC history and likely future. Finally, I will apply and compare the pillars that have led to a successful VC market in the U.S. to those implemented in Spain by way of the SCIF and government reforms Spain has taken to aid its VC market.
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19. Empresa Nacional de Innovación SA, *Spain Startup Co-Investment Fund*, http://www.enisa.es/en/innovation/info/enisa-programmes/spain-startup-co-investment-fund (last visited Jan. 26, 2014).

20. *Id.* The investments by SCIF comes in the form of loans that must be repaid.

21. LERNER, *supra* note 3, at 66.

22. *Id.*

23. *Id.*

24. *Id.* at 69.

II. The United Stated Venture Capital System

A. *Silicon Valley's Venture Capital History*

The U.S. venture capital market is the product of both organic process and government intervention. While a more complete history of the U.S.'s VC industry can be found in Section III below, this section focuses on the narrower sphere of Silicon Valley's history and foundation.

Starting during the Gold Rush, California's bar on covenants not to compete set the stages for the Californians' unique ability to break away from large companies and begin start-ups directly competing with former employers.[25] Furthermore, if not for the creation of Stanford University and its industrial park, it is questionable whether the start-up hub of Silicon Valley would have ever become the success it is today.[26]

In a study analyzing the importance of a biotech firms' location in relation to their IPO and capital funding, it was found that when biotech companies moved to the San Francisco area they were able to earn on average an additional $6.3 million in capital.[27] The study found that this was attributable to the Bay Area's research universities, information flow from other entrepreneurs, and the large labor pool.[28]

The question of how Silicon Valley became the VC and start-up giant it is today, however, may find its answer in a more simple explanation. "Some accounts leave the impression that the right and charismatic and talented people simply collaborated at the right time."[29] This more fortuitous view of Silicon Valley's foundation suggests that good timing and California's sunny weather may be the

25. *See* Gilson, *supra* note 1, at 1069.

26. *Id.* The effect government intervention had on U.S. VC will be explained in Section III.

27. David L. Deeds et al., *The Impact of Firm-specific Capabilities on the Amount of Capital Raised in an Initial Public Offering: Evidence from the Biotechnology Industry*, 12 J. OF BUS. VENTURING 31 (1997).

28. *Id.*

29. Abraham J. B. Cable, *Startup Lawyers at the Outskirts*, 50 WILLAMETTE L. REV. 163, 182 (2014); *see also* Abraham J. B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, 2 MICH. J. OF PRIVATE EQUITY & VENTURE CAPITAL 195, note 145 (2013).

best explanation for the world-renowned cluster.[30] While these chance events may have some effect on what created Silicon Valley, it seems unlikely to be the sole explanation for this major VC hub.

B. The Pillars of the United States' Venture Capital

The U.S. VC system relies on several pillars to create its success. In order to assess Spain's future for success in VC it will be important to consider these pillars in establishing what has lead to an effective U.S. system and apply these pillars to those implemented in Spain by way of the SCIF.

1. Pillar 1: The U.S. Legal Infrastructure

Fundamental to the Silicon Valley VC market is California's unique refusal to enforce non-compete agreements.[31] This is essential in the industry of start-ups, where employees of companies may wish to leave their current employer and begin their own business or join an emerging start-up. In so doing, they will often stay in an industry similar to that of their last employment and rely at least partially on the knowledge gained from previous employers.[32] This common scenario played out after technology giant, Hewlett-Packard, lost its former CEO, Mark Hurd, to Oracle.[33] In an article talking about the suit, it was noted that California "specifically does not want companies turning confidentiality agreements into after the fact non-compete agreements."[34]

Also, part of the legal structuring of the VC industry in the U.S. is the legal entity of limited partnerships. By making the VC fund a limited partnership, the investors may enjoy the benefits of limited liability and tax flow through.[35] Limited liability protects investors from potential suits or debts against the company, limiting the amount they will owe to no greater than the amount of their

30. Cable, *Startup Lawyers at the Outskirts*, *supra* note 29, at 179-80.

31. Jeremy Hitchcock, *Noncompete Claws: An Antiquated Restriction is Hurting Tech Growth in Massachusetts*, BOSTON GLOBE, Dec. 1, 2013.

32. *Id.*

33. Erica Ogg, *HP Suing Former CEO Mark Hurd*, CNET (Sept. 7, 2010, 2:44 PM), http://www.cnet.com/news/hp-suing-former-ceo-mark-hurd/.

34. *Id.*

35. *See* Learner, *supra* note 3, at 101-102.

investment. Taxes in limited partnerships flow through, meaning there is only a single taxation on the individual partners of the VC.[36]

The U.S. legal infrastructure also ensures that exit by way of an initial public offering will be possible. The ease of exit helps investors guarantee that, if the start-up is successful, they receive a high return for their risky investment. Exit also serves another purpose, as VC funds help entrepreneurs by providing important guidance and expertise as the start-up goes through its early stage and then allowing control to return to the entrepreneur after the IPO.[37] IPOs also recycle VC talent, allowing investors to find new ventures to pursue after exiting.[38] A study focusing on IPOs in the biotechnology industry found that "entrepreneurs need to be very selective when choosing their lead venture capital firms, lead underwriters, and CEOs," as this can have a large impact on the success of an IPO.[39]

U.S bankruptcy law plays an important role in the American entrepreneur's willingness to take risks. While in many other countries bankruptcy is socially unacceptable and feared, bankruptcy lacks this level of stigma in the U.S.[40] Outside the social repercussions associated with bankruptcy proceedings, there is also a very real risk for entrepreneurs who often use their own funds to provide the initial capital.[41] The U.S. bankruptcy law regime uniquely frees debtors from creditors seeking repayment after filing for bankruptcy. As the U.S. Supreme Court stated, the system gives the debtor a "new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[42] Without a "fresh start" program like the U.S. has, there is a very high risk for entrepreneurs that will prevent many from creating a start-up.

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36. *Id.*

37. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, *supra* note 29, at 229.

38. *Id.*

39. Todd Finkle, *The Relationship Between Boards of Directors and Initial Public Offerings in the Biotechnology Industry*, ENTREPRENEURSHIP: THEORY & PRAC. (Mar. 22, 1998), at 22.

40. Adrian Wooldridge, *Global Heroes: A Special Report on Entrepreneurship*, ECONOMIST, Mar. 14, 2009, at 6.

41. John Armour & Douglas Cumming, *The Legal Road to Replicating Silicon Valley* 3 (ESRC Centre for Business Research, Working Paper No. 281, 2004).

42. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

Finally, U.S. immigration policies, with a history of supporting openness to entrepreneurs, have played an important role in attracting bright minds from abroad.[43] Immigrants or their children founded approximately 40% of Fortune 500 companies in the U.S.[44] However, the U.S.'s open immigration policies have come to a slow, as the government is tightening immigration restrictions. This change in immigration policies has reportedly led Mark Zuckerberg (the founder and CEO of Facebook) and other entrepreneurs in Silicon Valley to begin planning a lobby for more open immigration policies.[45] While current U.S. immigration regulations are not providing the same openness that helped start-up ventures previously, the country's past open immigration policies were an important factor in creating successful companies.

In sum, the U.S. legal infrastructure laid the groundwork for the successful U.S. VC market, allowing a greater flow of ideas and brining in persons from abroad to add to the innovation pool. The U.S. legal framework also crucially incentivizes investors to fund new ventures by minimizing their risks and maximizing potential returns.

2. Pillar II: Incentivizing and Evaluating for Greater Performance

In the U.S., an angel investor or a group of venture capitalists (Limited Partners) will often provide the funding, and then look to a General Partner ("GP") to actually control the VC's investments.[46] It is therefore critical that this GP has a desire for the new venture to succeed. The GP generally has a 20% carried interest in the venture that is completely dependent on its success, incentivizing the GP to help the new venture grow and thrive.[47] Potentially even more

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43. *See* Wooldridge, *supra* note 40, at 7.

44. Stuart Anderson, *40 Percent of Fortune 500 Companies Founded by Immigrants or their Children*, FORBES, (June 19, 2011), http://www.forbes.com/sites/stuartanderson/2011/06/19/40-percent-of-fortune-500-companies-founded-by-immigrants-or-their-children/.

45. *Immigration and America's High-industry: The Jobs Machine*, THE ECONOMIST, (Apr. 13, 2013), http://www.economist.com/news/business/21576101-start-ups-founded-immigrants-are-creating-jobs-all-over-america-jobs-machine.

46. *See* Gilson, *supra* note 1, at 1071.

47. Todd Hixon, *An Insider Perspective on Carried Interest*, FORBES, (Feb. 2, 2012), http://www.forbes.com/sites/toddhixon/2012/02/02/an-insider-perspective-on-carried-interest/.

incentivizing is the effect of past performance on the GP's reputation in the VC community.[48] Upon the end of a GP's control of a fund, usually terminated after ten years when liquidation becomes mandatory, the GP will then seek to manage a new fund.[49] This provides a strong incentive to perform well, so the GP's reputation among the VC community remains positive. It is this reputation that will safeguard the GP's career, and in turn protect the Limited Partners.

The U.S. system also focuses on the importance of structuring the legal relationship in order to decrease the risk for investors.[50] It does this by providing investors "more control than equity" in their investments.[51] VC investors may use staged financing as one method of control, whereby the start-up must meet certain requirements and goals emplaced by the VC before they will provide the next round of funding.[52] These check-ins allow the VC investors to protect their investment by verifying that progress is being made according to their specifications prior to providing additional funding. A second form of control can be contracted into the VC agreement with the start-up; here, the VC investors are given partial or complete control of the emerging company's board of directors.[53] This allows the VC investors to protect their investments and have greater regulation over the direction of the emerging company.

A final factor assisting in assurance for greater performance is evaluation of the entrepreneur's track record prior to investing.[54] It is crucial that the investor know as much about the entrepreneur's vision and past performance as possible to ensure the greatest likelihood for success.

48. *See* Gilson, *supra* note 1, at 1071.

49. *Id.; See also Committee on Small Business House of Representatives,* 109th Cong. (2007) (Statement of Mr. Redding regarding the importance of SBIC funding for ventures that cannot receive VC, but go on to succeed with SBIC funding. The report also discusses the problems facing the SBICs.)

50. *See* Gilson, *supra* note 1, at 1088

51. *Id.* at 1082.

52. *Id.*

53. *Id.*

54. *See* Learner, *supra* note 3, at 142.

3. *Pillar III: The United States Culture and Perspective*

The entrepreneurial culture of the U.S. plays an important part in supporting those who are willing to take the risk to create a start-up. The U.S. has long been considered a society of dreamers, who are more open to innovation than recreation. "America plays a vital role in spreading the culture of entrepreneurialism around the world. People the world over admire its ability to produce world-changing entrepreneurs, such as a Bill Gates, wealth-creating universities such as Harvard and Stanford, and world-beating clusters, such as Silicon Valley."[55] The U.S. also boasts consumers that are more willing to take risks than most.[56] With the wave of new technology and complex programs, there must also be consumers who are willing to learn the skills necessary to use the new gadgets and products that start-ups are building.

4. *Pillar IV: The United States Higher Education System*

The U.S. higher education system plays a strong role in cultivating young entrepreneurs. Stanford University in particular has a close tie to the start-up society in Silicon Valley.[57] In fact, about half of all start-ups in Silicon Valley trace their beginnings to Stanford University.[58]

III. The United States Government Funded Venture Capital Programs

A. *History*

The catalyst for U.S. VC was the end of the Great Depression and a widespread fear of yet another economic downturn after the war's end.[59] In 1956, American Research Development ("ARD") became the first government-funded program created to finance new ventures. ARD, however, ultimately failed due to the tensions between its goals of public benefit and profitability.[60]

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55. *See* Wooldridge, *supra* note 40, at 7.
56. *Id.*
57. *Id.*
58. *Id.*
59. *See* LERNER, *supra* note 3, at 39.
60. *Id.* at 38.

Twelve years later, the government again looked to government funded VC to help the market, this time creating a program that enabled the Small Business Administration (SBA) to invest in Small Business Investment Companies (SBICs). This effort at publicly funded VC was much more successful, investing in companies such as Apple, Intel and Compaq when they were still young start-ups. Arguably its greatest contribution to the U.S. VC market was the creation of an infrastructure in Silicon Valley, which private investors were later able to use to ease the costs associated with new ventures.[61]

While the SBICs played an important role in VC, they are now arguably unnecessary, as the SBA program failed to adapt and sufficiently change with the industry.[62] In 1995, SBICs owed the SBA $501 million, $252 million of which the SBA predicted it would not get back due to failure of the new ventures.[63] Another commonly cited criticism is the over-regulation of the program. SBICs, however, remain an active government program and are sometimes credited with playing an important role at its inception in creating a basis for future VC in Silicon Valley.[64]

B. *Criticisms of Government Venture Capital Programs*

Government funded VC has not been without its critics. It is important to consider the potential pitfalls of government VC in order to analyze the capacity of the SCIF to avoid them. First among the possible pitfalls is over-funding that may result in crowding, effectively wasting funds and actually competing with private funds to the point of their removal from the market.[65] A second common criticism, one that can be seen in both the ARD and SBIC programs in the U.S., is lack of flexibility.[66] It is crucial for VC funds to assess each investment individually, and set requirements and goals for that

61. *Id.* at 38-39.

62. Byrne A. Bowman, *SBICs: Pioneers in Organized Venture Capital*, 26 THE BUS. LAW. 1793, 1793 (1970-1971).

63. *See* Mehta, *SBA's Program Will Show Millions of Dollars in Losses, GAO Says*, WALL ST. J., Sept. 29, 1995, at B2.

64. *See* LERNER, *supra* note 3, at 10. *See also* LINDA WEISS, AMERICAN INC.?: INNOVATION AND ENTERPRISE IN THE NATIONAL SECURITY STATE 57 (2014).

65. *See* Armour, *supra* note 41, at 3.

66. *See* Learner, *supra* note 3, at 125.

particular company. It has also been noted that failure to meet requirements set out for SBIC management has not been closely policed, resulting in questionable business practices by management.[67]

Thirdly is the criticism that government VC does not invest in the best locations, as political sway pulls government funding to where constituents are.[68] Finally, a fundamental problem with design of SBICs is the debt structure that requires repayment to the SBA on a fixed schedule.[69] The nature of start-ups does not allow for regular payment of a loan, as capital will often not be available because start-ups are in their initial growth stages.[70] Instead, start-ups provide their returns to investors at exit, making SBIC funding impractical for young start-ups without capital.

IV. Spain's Venture Capital System

A. History

Spain's first public efforts to create a VC market in the country were between the years 1970 and 2000, but these investments largely focused on traditional and more developed (not start-up) markets.[71] Spain was hit hard by the 2001 Dot-Com Bubble burst as "the share of total venture-capital investments made in high technology ventures . . . dropped from 26.2% in 2000 to 8.9% in 2001."[72] This drop resulted in investors shifting their few early-stage investments to more traditional markets and avoiding the emerging technology sector.[73] Starting around 2000, the government began to take a greater interest in promoting early-stage investments for high-tech firms, most notably through the creation of NEOTEC in 2000.[74] The government took a very hands-on role under the program, deciding

67. *See* Mehta, *supra* note 63.

68. *Id.* at 135.

69. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, *supra* note 29, at 205.

70. *Id.*

71. Del-Palacio, *supra* note 17, at 283.

72. *Id.* at 287.

73. *Id.*

74. *Id.*

which companies to invest in and monitoring their progress.[75]

In an effort to pull itself out of a VC lull between 2004 and 2005 the Spanish government passed new tax codes and Ley 25/2005, effectively lowering taxes for VC companies and investors and alleviating legal restrictions on VC investors.[76] Finally, in 2005 the government created ENISA to provide public funding for VC.

B. The Startup Co-Investment Fund

ENISA and the IE Business School set up a public-private partnership whereby ENISA will match equity investments by accredited investors with loans of up to 1.5 million euros.[77] The program requires investors to meet an initial set of requirements. For VC co-investment partners, they must: (1) have made at least three investments in an unlisted company within the prior two years; (2) work or have worked within the past two years "in a professional capacity in the venture capital sector," or have advised or financed small to medium companies, or have been a director of a company with annual earnings of at least 1 million euros; and (3) have a fund of 1 million euros or have liquid assets (accessible to invest) of 500,000 euros.[78] For angel investors, requirements one and two are the same, the difference being requirement three: (3) the investor must be a natural person (not a legal entity) with a net worth (or joint with spouse) of at least 1 million euros or liquid assets (accessible to invest) of at least 100,000 euros.[79]

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75. *Id.*

76. "Ley" means "law" in Spanish. Disposiciones Generales (B.O.E. 2005, 282) (Spain); Norman A. Hernandez & Roberto Santillán, *An Overview of Spain's Venture Capital Industry*, TECNOLÓICO DE MONTERREY (Mar. 19, 2010).

77. Gobierno de Espana, *Spain Startup Co-Investment Fund*, http://www.enisa.es/en/innovation/info/enisa-programmes/spain-startup-co-investment-fund.

78. Gobierno de Espana, *SSCF Venture Capital Co-Investment Partner Application Form*, https://spainstartupcoinvestmentfund.es/Form.aspx?locale=en-US&type=1&cl=1.

79. Gobierno de Espana, *SSCF Business Angel Co-Investment Partner Application Form*, *https://spainstartupcoinvestmentfund.es/Form.aspx?locale=en-US&type=2&cl=1.* An interesting aspect of the SCIF program is its creation to foster both angel investors and VC. Angel investment funds are generally used for start-ups at the beginning of their life cycle, while VC funding usually comes subsequent. Whether the same program can successfully foster both remains a question. *See also*, Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, *supra* note 29, at 206-08.

Once accredited, an investor submits loan applications to ENISA on behalf of the companies in which they have invested.[80] The program guarantees a response within 15 days for those seeking funding less than 300,000 euros, and 45 days for those investments in excess of 300,000 euros.[81] ENISA has a cap of 1,500,000 euros of investment per company.[82] After the loan is provided, the SCIF requires annual accounts of the company's progress and notification of major modifications in corporate structure or business plans.[83] There is no involvement by the SCIF or ENISA in the corporation's board or shareholder meetings.[84]

The loan provided requires no collateral, and the SCIF waives principal payments for the first two to four years (the duration depending on the company's projections for when they will break even).[85] However, payment on the principle must start at the specified date, regardless of whether the company has met its projections.[86] Interest rate payments start immediately, and vary in amount depending on the profitability of the company.[87] Should there be a default, the loans are subordinated, meaning they have low seniority for repayment.[88]

C. The Current Progress of the Startup Co-Investment Fund and the VC Market in Spain

In its most recent report, Spain's SCIF had 113 accredited investors, 24 of which were foreign investors from around the globe, including the U.S., Denmark, France, and Russia.[89] The SCIF program places among its goals attracting funding from non-Spanish

80. E-mail from Cormac Leggett, Institutional Relations of ENISA, to author (Apr. 2, 2014, 3:03 PDT) (on file with author).

81. Gobierno de Espana, *Spain Startup Co-Investment Fund*, http://www.enisa.es/en/innovation/info/enisa-programmes/spain-startup-co-investment-fund.

82. *Id.*

83. E-mail from Cormac Leggett, *supra* note 80.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. Gobierno de Espana, *Spain Startup Co-Investment Fund Nota Informativa* (on file with author).

investors.[90] For each euro funded by ENISA, private investors have provided 2.8 euros.[91] From October 2013 to October 2014, SCIF investments equaled approximately 24 million euros, and accredited investors contributed 44.6 million euros to fund a total of 141 operations.[92] These numbers are up approximately 10 million euros from the October 2012 to October 2013 report.[93]

Spain's overall VC market leading up to the inception of the SCIF was taking a downturn. In 2012, total VC investments equaled 158 million euros, decreasing 22.8% from 2011.[94] Of those funds, 77% of the total invested were by private entities, while the remaining 23% were by public entities.[95] With the Spanish economy suffering an overall depression, high unemployment, and decreased consumption, government assistance with early-stage funding through organizations such as ENISA serves an important role.[96]

In the most recent report reflecting Spain's VC market in 2013, overall VC investments decreased by 7.5% from 2012.[97] The 2013 VC market, however, took a noticeable upturn at the start of the summer, suggesting 2014 will be a more successful year for VC in Spain (market numbers are not out yet).[98] 80% of the total amount invested in 2013 was realized in the second half of the year.[99] While the overall decrease is not what supporters of SCIF would like to see post-enactment of the program, the upturn in the last half of 2013 suggests the numbers in 2014 may show an increase in VC investments.

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90. *Id.* This goal is interesting, as angel investors traditionally invest in ventures located near them regionally. FAQs on Angel Investing, ANGEL CAPITAL ASSOCIATION (Mar. 28, 2013, 1:14 PM), http://www.angelcapitalassociation.org/entrepreneurs/faqs/.

91. *Id.*

92. *Id.*

93. *Id.*

94. Associacion Espanola de Entidades de Capital Riesgo, *Venture Capital & Private Equity in Spain 2013*, 1, 22.

95. *Id.*

96. *Id.* at 11, 24.

97. Associacion Espanola de Entidades de Capital Riesgo, *Venture Capital & Private Equity in Spain 2014*, 1, 9, http://www.ascri.org/upload/publicaciones/20140626_084042_1985245700.pdf.

98. *Id.*

99. *Id.*

V. Comparison Between the United States VC System and Spain's SCIF Program

A. *The SCIF Compared to The U.S. Government Funded ARD*

The U.S.'s first government funded VC, ARD, was ultimately unsuccessful due to "bureaucratic constraints, lack of professional expertise, and a faulty design of capital structure and incentives."[100] SCIF will have to be cautious of the common pitfall to government programs, over-regulation and inflexibility due to the bureaucratic nature of governments. In the investment terms, SCIF does place time constraints, promising to inform potential investors quickly whether they will qualify.[101] This guarantee of speediness seems to be an effort not to allow the bureaucratic nature of government to effect timeliness. The level of oversight and regulation by the SCIF over the start-ups is limited, only requiring annual accounts and notification of major events.[102] This limited regulation seems to account for much of the over-regulation problem that befell ARD. Whether the program will be sufficiently flexible with changing markets, however, remains to be seen.

Spain appears to have accounted for the concern of professional expertise. The SCIF is not solely a government program; instead, it created the program in conjunction with the world-renowned IE Business School. As shown by the success of the partnership between Silicon Valley and Stanford University, it is wise for Spain to look to the University for professional expertise. Furthermore, the criteria for the accredited investors (enumerated in Section IV) include a foundational understanding of VC and entrepreneurial experience. In terms of incentives, SCIF's program matches investors, but it does not provide the entire capital for the investments. Josh Learner notes, "[p]rograms are more successful if the entrepreneurs or venture capitalists receiving public funds have to raise matching capital from private sector sources as well. In this way, the market can help sort out which players are likely to succeed and who will probably be

100. Laura Bottazzi and Marco Da Rin, *Venture Capital in Europe and the Financing of Innovative Companies*, 17 ECON. POL'Y 1, 4 (2002); *accord* Joshua Lerner, *Venture Capitalists and the Decision to go Public*, 35 J. OF FIN. & ECON. (1994).

101. *See* Gobierno de Espana, *supra* note 77.

102. E-mail from Cormac Leggett, *supra* note 80.

ineffective."[103] Therefore, it seems that Spain's program has accounted for many of the pitfalls that befell ARD.

B. Spain's SCIF Compared to the U.S. Government-Funded SBICs

The second major government-funded VC program was the SBA's investment in SBICs. The SBICs received tax benefits and could borrow up to half of their capital from the government.[104] One of the greatest criticisms of the program is its poor returns and high instances of fraud. This was likely due to SBICs sometimes being "run by inexperienced financiers who undertook lines of business very different from those originally intended by Congress".[105] The SCIF's requirements for accreditation of investors (enumerated in Section IV), as discussed in the comparison to ARD, seem to be created to combat these concerns of inexperienced investors. By requiring investors to have made recent prior investments and have work experience in emerging growth companies or large corporations, the SCIF will likely avoid the SBA's pitfall of inexperienced financers.

A second common criticism of the SBICs is the large amount of red tape, similar to the bureaucratic criticism of its predecessor, ARD.[106] Despite these criticisms, SBICs arguably played a catalytic role in the creation of the Silicon Valley infrastructure that still thrives today.[107] The red tape issue will be one that Spain needs to take great caution with, as this is a problem that often pervades government programs. It appears that, at this time, SCIF is not yet falling victim to this problem, but that does not mean it will not in the future.

A third criticism is the debt repayment structure of SBICs, requiring repayment at a time when young start-ups will likely not have sufficient funding to re-pay the loan.[108] The repayment structure of the SCIF requires interest payments starting immediately upon receipt of the loan, but payment on the principle is pushed back

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103. *See* LERNER, *supra* note 3, at 135-136.

104. *Id.* at 38.

105. *Id.*

106. *See* Bowman, *supra* note 62, at 1.

107. *See* LERNER, *supra* note 3, at 38-39.

108. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, *supra* note 29, at 205.

two to four years.[109] This repayment system does not allow investors to push back repayment if their new venture falls short of their projections.[110] The required repayment regardless of the company's success, like the SBICs had, suggests that the SCIF's payback system could fall subject to the same problems the SBICs did in this regard.

Lastly, critics point to the inflexibility and susceptibility to interest group pressures as a major problem with the SBIC's continued funding, suggesting that while it once played an important role in creating a U.S. VC market, its time has come to an end.[111] The flexibility issue is one that also seems to strike many government-run programs. The difficulty presented by government sponsored VC is it will often have guidelines that are placed on all investors and all companies seeking funding. Meanwhile, not all industries or entrepreneurs are the same, and therefore it seems important for Spain's SCIF to focus on the need to consider the individuality of the industry and investment.

C. *Spain's SCIF's Relation to the U.S. Pillars of VC*

While every nation is unique in its structure and people, and therefore it would be nearly impossible to use the same VC structure in every country, it will be helpful to consider the foundation that has led to a successful U.S. VC in comparison to Spain's pillars. In other words, even if a VC subsidy program is well-designed, environmental factors in the relevant economic region may thwart efforts to boost VC.

1. *The Spanish Legal Infrastructure*

Spain's legal infrastructure allows express agreements not to compete. The agreements must be limited in geographic scope, duration (2 years for upper management persons and 6 months for all others), and can only cover similar duties and occupations in a similar professional sector.[112] If there is no express agreement for such a

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109. E-mail from Cormac Leggett, *supra* note 80.

110. *Id.*

111. *See* Bowman, *supra* note 62, at 1.

112. Stephan C. Swinkles, *Top Ten Considerations for Non-compete Clauses in Europe (The Netherlands, Belgium, Spain, German, France, Italy)*, ASSOCIATION OF CORPORATE COUNSEL 1, 2 (June 9, 2011), http://www.acc.com/legalresources/publications/topten/Non-compete-Clauses-in-Europe.cfm.

covenant, then Spain's unfair competition laws prevent employment with a secondary employer while still being employed by the first employer if the employee is doing similar tasks that cause actual or potential harm.[113] This legal structure is less conducive to start-ups than that of California, where employees have greater mobility.[114] This may prove to be a disadvantage in Spain's evolving VC market.

It has been noted that in Spain, the "entrepreneurial processes have still not been standardized, and venture-capital investments require much effort from entrepreneurs and entail high risk for investors".[115] It is therefore important for the government to take the necessary legal structuring steps to make the VC process more standardized and, in turn, more attractive to investors. In 2005 the government enacted Ley 25/2005, which lessened legal restrictions for companies to invest in VC.[116] It also had the effect of making VC funds a separate legal entity, limiting liability as limited partnerships do in the U.S. system.[117] Limited liability is crucial in inducing investors to provide capital.

Under the U.S. legal system, limited partnerships also afford tax benefits. In 2004 Spain passed new tax laws that included large tax incentives for VC.[118] Included in the tax benefits are: a 99% exemption of qualified capital gains, withholding tax exemptions for nonresidents holding shares in VC entities, and additional benefits for nonresidents involved in VC.[119] The new tax laws prevent a fund manager's mere presence in a foreign country for VC purposes from establishing residency sufficient to result in double taxation.[120] "Such

113. *Id.* at 6.

114. *See* Hitchcock, *supra* note 31.

115. Del-Palacio, *supra* note 17, at 286.

116. Ley 25/2005 (Nov. 24, 2005), http://www.boe.es/buscar/act.php?id=BOE-A-2005-19412 [for English: http://www.ascri.org/upload/legislacion/20120904_ 120659_ 630236798.pdf]. The 2005 law supplements the Ley 1/1999, which regulated VC in Spain. Under the 2005 version VCs are given greater flexibility in deadlines, and the administration necessary for incorporation and amendments of bylaws are improved.

117. *Id.* at Capitulo II, Articulo 32.

118. Carles Farre, *Spain Provides New Tax Benefits for Venture Capital Activities*, 33 TAX NOTES INT'L. 373, 373 (Jan. 26, 2004).

119. *Id.*

120. *EU Reports on Tax Obstacles to Cross-Border Venture Capital Investing*, WORLDWIDE TAX DAILY (May 3, 2010), https://advance.lexis.com/GoTo

double taxation can make investing in private markets uneconomic for investors" and prevent their willingness to fund VC.[121] This tax law will certainly benefit Spain and place it in a more competitive position in the VC market.

Ease of exit via an IPO in Spain is much more complicated than in the U.S. mostly due to the lack of a strong stock market, like the U.S.'s NASDAQ or the New York Stock Exchange.[122] Inability to easily exit the market is not only unattractive to VC investors who want to recoup their funds and make money, but also harms the overall market as VC investors often re-invest from the proceeds of their last exit. This can have a negative cyclical effect on the sustainability of the VC industry in a country. Europe has tried to create its own markets before, but still lacks "an electronics sector stock market specializing in growth or high-tech enterprise securities, similar to NASDAQ in the United States."[123] However, it has been noted that exit through an IPO may not always be the best method, and exit by merger (also known as a trade sale) may be more optimal for those seeking a quicker payout.[124] By increasing the potential forms of non-IPO exits, VCs can "bridge the liquidity gap in the VC cycle and reduce fragmentation of the VC industry."[125] In other words, VCs can receive their return on investments more rapidly and then use those returns to re-invest in new start-ups. As Mendoza and Vermeulen noted in their article, government involvement in the creation of pre-IPO marketplaces can help provide important support for the VC cycle.[126] This alternative exit method may be useful in Spain, suggesting that Spain would be smart to concentrate some of its efforts in creating a robust pre-IPO marketplace.

ContentView?requestid=65e9d49b-e38a-1dee-89cd-daf2760d51b2&crid=8b27de7b-313-295c-6a66-5d9888e653b.

121. *Id.*

122. European Commission *supra* note 18, at 1.

123. *Id.*

124. Darian M. Ibrahim, *Should Angel-backed Start-ups Decline Venture Capital,* 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 251, 252 (2013).

125. Jose Mendoza & Erik P.M. Vermeulen, *The "New" Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* 1, 37 (Lex Research Topics in Corporate Law & Economics, Working Paper No. 1, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835.

126. *Id.*

Bankruptcy law in Spain differs from the U.S., where the European society as a whole has "more punitive attitudes to bankruptcy."[127] Spain traditionally does not discharge the debtor from their debts, however, in 2012, a new law came into effect creating "creditor arrangements" to structure loan repayment and avoid bankruptcy for businesses.[128] However, the debt restructuring alteration to Spain's bankruptcy laws does not provide new investors senior status for repayment, so the program remains largely unused.[129] U.S. bankruptcy law has been attributed to the willingness of its citizens to take larger risks. A reform in Spanish bankruptcy law may be necessary to promote Spanish VC.[130]

Finally, immigration law within Spain was changed starting October 1, 2013. "The primary objective of this new law is to encourage foreign investment and attract highly skilled workers in Spain."[131] The law creates a Fast-Track process for residency for intra-company transfers, investors, highly qualified professionals and managers, entrepreneurs and researchers.[132] The new Spanish immigration law is very favorable to entrepreneurs and investors and should have a positive effect on the VC market within the country.

2. Incentivizing and Evaluating for Greater Performance

The SCIF uses a set of qualified investor criteria to evaluate who will be a good fit to manage the funds. Investment performance is tracked by the company's annual accounts but is largely left to the

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127. Del-Palacio, *supra* note 17, at 286; *accord* Wooldridge, *supra* note 40, at 7.

128. Deborah Ball, *Europe Builds Own Chapter 11*, WALL ST. J., Apr. 5, 2013, http://online.wsj.com/news/articles/SB10001424127887323296504578398612178796882. *Spain Bankruptcy Legal Requirements*, EUROPA.EU, http://europa.eu/youreurope/business/start-grow/start-ups/index_en.htm#spain_en_handling-bankruptcy-and-starting-afresh (last updated Dec. 2012).

129. Ball, *supra* note 128.

130. Isabel Escevarría Aburto, *¿Cuantó cesta crear una empresa en España?*, CINCO DIAS (Dec. 12, 2012), http://cincodias.com/cincodias/2012/12/11/economia/1355466509_850215.html.

131. *Immigration Changes in Spain Aim to Attract Investors, Entrepreneurs, Highly Qualified Workers, and Major Companies*, PRO-LINK GLOBAL (Oct. 30, 2013), https://pro-linkglobal.com/spain-immigration-changes-in-spain-aim-to-attract-investors-entrepreneurs-highly-qualified-workers-and-major-companies/.

132. *Id.*

investors.[133] It is unclear from publicly available information, however, whether the SCIF program will have the ability to shut down a company if it is not making progress. The need to make loan repayments will require some level of success, especially once the principle becomes due after the initial grace period.[134] U.S. systems often rely on control and staged funding to assist with this, which the SCIF does not do. However, Spain's SCIF does require investors to match capital, therefore incentivizing them to succeed in order to protect their own investments. Whether this will be enough to incentivize is uncertain, and it will be necessary to watch how the SCIF plays out.

3. Spain's Culture and Perspective

It has been said that "Europeans are . . . much more suspicious of business."[135] The U.S. has often been regarded as unique for its entrepreneurial character and risk-taking citizens. "It is said that in San Francisco, failure is worn more like a badge of honor."[136] Opposite to this risk-accepting culture is that of Europe, where taking a more reliable job with steady pay is regarded as admirable.[137] The European perspective ultimately has been attributed to what "stifles those with the potential to be great entrepreneurs."[138] In Spain in particular, the youth "still prefer the supposed security of working at well-known corporations even though many are now laying people off."[139]

In order to invoke a change of culture, it seems likely that something more than a government-funded program would be necessary. How to change the views of persons and their culture is a complex question, which may find potential resolution in the education system. This issue, however, is one best suited for a

133. E-mail from Cormac Leggett, *supra* note 80.

134. *Id.*

135. Armour, *supra* note 41, at 7.

136. Andrea Francis, *Why haven't European investors fully accepted the "failure is good" mentality yet?*, THE NEXT WEB (Mar. 2, 2014, 12:04 PM), http://thenextweb.com/ entrepreneur/2014/03/02/havent-european-investors-fully-accepted-failure-good-mentality-yet/?fromcat=all#!zkfif.

137. *Id.*

138. *Id.*

139. Clare Kane, *"Crisis is outside"; Spain's Tech Entrepreneurs Far Removed From Budget and Job Cuts*, NAT'L POST (Can.), Aug. 7, 2012, at 9.

separate research inquiry.

4. *Spain's Higher Education System*

The SCIF is a program created in conjunction with the IE Business School of Madrid. Ranked number eleven in the world in 2013 according to the Financial Times report, the University boasts an excellent reputation among business schools.[140] This kind of connection between a university and the VC market is the type of link that Stanford shares with Silicon Valley. It will serve Spain's VC market well to continue this relationship and work closely with the university to help promote start-ups and entrepreneurship.

VI. Conclusion

In Spain's current state of financial instability and economic recession, it is increasingly difficult to fund new ventures.[141] Spain is presently facing the issues of high debt, low international competitiveness, and a weakened euro.[142] In 2013, unemployment in Spain had reached 56% for those under twenty-five years of age.[143] These serious issues facing the country are ones that the Spanish government is certainly trying to combat with a long-term economic plan. It has been recently noted that the high youth unemployment rate "appears to be starting to force ingenuity, innovation and creativity among young professionals who are taking risks and bucking the security under the umbrella of an established business."[144]

In an empirical study, it was found that the "Spanish venture-capital market has rapidly developed in the last 10 years and that this development coincides with the establishment of public policies for encouraging technology entrepreneurship".[145] This finding suggests

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140. *IE Business School Rankings*, FINANCIAL TIMES (accessed Feb. 1, 2014, 11:09 AM), http://rankings.ft.com/businessschoolrankings/ie-business-school.

141. Dominique Barthel, Ángela Aflérez, José Martí Mellón & Marcos Salas de la Hera, *Venture Capital & Private Equity in Spain*, ASOCIACIÓN ESPAÑOLA DE ENTIDADES DE CAPITAL RIESGO, 55.

142. *Id.* at 53.

143. Stephen Burgen, *Spain Youth Unemployment Reaches Record 56.1%*, THE GUARDIAN, Aug. 30, 2013.

144. Clendenning, *supra* note 16.

145. Del-Palacio, *supra* note 17, at 283.

that the public policies and regulations aimed at fostering entrepreneurship, coupled with Spain's SCIF, may be a recipe for an improved Spanish VC market. The strong link between a country's VC and entrepreneurship and its overall economic success presents a hopeful horizon for Spain's future overall economic prosperity.[146]

The program requirement of experienced co-investors and its close connection to the IE Business School are both positive aspects that emulate some of the successful U.S. public VC efforts. The seemingly largest concern with the SCIF program is its loan repayment system, which does reflect some of the same repayment methods that proved unsuccessful for the SBA's SBICs. Spain has clearly made a commitment to improving its VC attractiveness through more open immigration policies and business-friendly tax incentives. These important foundations were crucial to the U.S. VC market, and will likely serve Spain well. Whether the U.S. entrepreneurial and risk-taking culture can be replicated, however, is a question left unknown. The ability to measure this consideration in precise numbers is difficult, and even more difficult to replicate.

Spain is clearly on a good path, implementing many programs and rules that were pillars in the successful U.S. VC market creation. While much of the U.S. VC foundation was the result of an organic process (coupled with strategic government funded programs), the ability to replicate this through government intervention may be possible. Whether Madrid has the capacity to become the next Silicon Valley is uncertain, but Spain's SCIF is a good effort at jumpstarting the VC market in the country.

146. *See* LERNER, *supra* note 3, at 43.